

Message Text

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PASS CEA, TREAS, FRB

E.O. 11652: N/A
TAGS: OECD, ECON
SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF YUGOSLAVIA

REF: EDR(77)10

1. SUMMARY: IN REFDOP CIRCULATED FOR APRIL 27 EDRC
REVIEW OF YUGOSLAVIA, SECRETARIAT NOTES THAT GROWTH
OF YUGOSLAV SOCIAL PRODUCT IN 1976 WAS SLOWER THAN
PLANNED WITH WEAKNESS LARGELY DUE TO SLUGGISH
PERFORMANCE OF DOMESTIC DEMAND. IMPROVEMENT OF REAL
FOREIGN BALANCE PROVIDED MAIN SUPPORT TO GROWTH IN 1976,
WHILE WEAK DOMESTIC DEMAND CONTRIBUTED TO DECELERATION
OF INFLATION. THIS PATTERN WAS REVERSED IN EARLY 1977
WITH ACCELERATION OF DOMESTIC DEMAND AND PRICE
INCREASES ACCOMPANIED BY DETERIORATION IN EXTERNAL
POSITION. FOR 1977 SECRETARIAT FORESEES HIGHER GROWTH
THAN REGISTERED IN 1976 (BUT WITH LITTLE IMPROVEMENT
IN LABOR MARKET SITUATION) AND RETURN TO CURRENT
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ACCOUNT DEFICIT. IN ADDITION, SECRETARIAT EXPRESSES
DOUBT THAT YUGOSLAV AUTHORITIES WILL BE ABLE TO HOLD
INCREASE IN CONSUMER PRICES TO THE 12 PERCENT
OFFICIALLY TARGETED. SECRETARIAT PRESENTS BRIEF
DESCRIPTION OF NEW YUGOSLAV FIVE YEAR PLAN (1976-80)
AND EMPHASIZES THAT GREATEST CHALLENGE FACED BY
POLICY MARKERS OVER NEXT FEW YEARS WILL BE CREATION OF

JOB ON SCALE SUFFICIENT TO ABSORB RAPIDLY EXPANDING LABOR FORCE. WHILE RECOMMENDING TIGHTER MONETARY POLICY IN 1977 THAN PRESENTLY ENVISAGED BY YUGOSLAVS, SECRETARIAT FOCUSES ITS RECOMMENDATIONS ON INSTITUTIONAL AND STRUCTURAL REFORMS DESIGNED TO ENHANCE EFFECTIVENESS OF DEMAND MANAGEMENT POLICIES, TO CREATE EMPLOYMENT AND TO IMPROVE EXTERNAL PERFORMANCE. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD BE USEFULLY POSED AT REVIEW. FOR BELGRADE: MISSION WOULD WELCOME EMBASSY'S COMMENTS ON SECRETARIAT'S ANALYSIS AND RECOMMENDATIONS, AS WELL AS PARTICIPATION BY EMBASSY REP IN REVIEW.
END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: SECRETARIAT NOTES THAT 3-1/2 PERCENT GROWTH OF REAL SOCIAL PRODUCT REGISTERED IN 1976 WAS CONSIDERABLY SHORT OF OFFICIAL TARGET (5-1/2 PERCENT) AND WAS MAINLY DUE TO WEAKNESS OF DOMESTIC DEMAND, PARTICULARLY INVESTMENT. IN SECRETARIAT VIEW, DIP IN INVESTMENT RESULTED PRIMARILY FROM TEMPORARY EFFECT OF NEW LAWS CONCERNING BUSINESS FINANCING AND ACCOUNTING PROCEDURES. THESE LAWS CONTAIN FOLLOWING MAIN FEATURES: (A) PERIODIC REVALUATION OF FIXED ASSETS AND CALCULATION OF DEPRECIATION ON BASIS OF REVALUED ASSETS; (B) INVENTORY PROFITS NO LONGER COUNTED AS INCOME AVAILABLE FOR DISTRIBUTION; (C) TIGHTENED CONTROLS ON INTER-ENTERPRISE FINANCING. SECRETARIAT FEELS THAT THESE REFORMS WILL HAVE SALUTORY EFFECTS OVER MEDIUM TERM, BUT NOTES THAT SHORT-RUN LIMITED OFFICIAL USE

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RESULT WAS LIQUIDITY SQUEEZE AND FALL IN INVESTMENT.

3. MODERATE RISE IN IMPORT PRICES (2 PERCENT IN DOLLAR TERMS), WEAK DOMESTIC DEMAND AND PRICE CONTROLS CONTRIBUTED TO SLOWEST RISE (12 PERCENT) IN CONSUMER PRICES SINCE LATE 1960'S. HOWEVER, ALTHOUGH EMPLOYMENT INCREASED BY ABOUT 3-1/2 PERCENT, NET IMMIGRATION OF 180,000 LED TO SHARP RISE IN NUMBER OF REGISTERED JOB SEEKERS.

4. OUTLOOK FOR 1977: SECRETARIAT STATES THAT OFFICIALLY TARGETED 5-1/2 PERCENT INCREASE IN REAL SOCIAL PRODUCT IS WITHIN RELATIVELY EASY REACH IN 1977, DESPITE LIKELIHOOD THAT GROWTH RATE WILL DECELERATE DURING YEAR. SECRETARIAT ADDS, HOWEVER, THAT 3 PERCENT INCREASE IN EMPLOYMENT ENVISAGED BY YUGOSLAVS WOULD REQUIRE A DECLINE IN PRODUCTIVITY, A DEVELOPMENT SECRETARIAT SEES AS UNLIKELY, GIVEN SIGNIFICANT PRODUCTIVITY GAIN ALREADY RECORDED IN EARLY 1977. IMPLICATION IS THAT UNEMPLOYMENT

COULD RISE FURTHER THIS YEAR (SECRETARIAT DOES NOT

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PRESENT SPECIFIC ESTIMATES).

5. SECRETARIAT UNDERLINES DANGER OF RENEWED WAGE/PRICE SPIRAL IN 1977. WHOLESale PRICES ROSE BY ONLY 6 PERCENT IN 1976 DESPITE SHARP RISE IN UNIT LABOR COSTS RESULTING FROM 16 PERCENT INCREASE IN AVERAGE EMPLOYEE COMPENSATION AND STAGNATION OF PRODUCTIVITY GROWTH. THUS, WHILE PRODUCTIVITY GROWTH IN EARLY 1977 MODERATED UPWARD PATH OF UNIT LABOR COSTS, SECRETARIAT NOTES THAT RECOVERY IN DEMAND COULD WELL BE ACCOMPANIED BY ACCELERATION OF INFLATION AS FIRMS ATTEMPT TO REVERSE SQUEEZE ON THEIR PROFIT MARGINS. MOREOVER, SECRETARIAT POINTS TO 53 PERCENT GROWTH M1 IN 1976 AS IMPORTANT POTENTIAL SOURCE OF INFLATION THIS YEAR. YUGOSLAVS HAVE TARGETED 12 PERCENT RISE IN CONSUMER PRICES IN 1977; SECRETARIAT DOUBTS THAT OFFICIAL GOAL IS ATTAINABLE.

6. CURRENT ACCOUNT: SPURRED BY RAPID RECOVERY IN OECD AREA DURING FIRST HALF OF 1976, YUGOSLAV EXPORT VOLUME
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ROSE BY 15-1/2 PERCENT, WHILE SLUGGISH DOMESTIC DEMAND RESULTED IN 5-1/2 PERCENT FALL IN VOLUME OF IMPORTS. FAVORABLE VOLUME MOVEMENTS, TOGETHER WITH IMPROVEMENT IN TERMS OF TRADE AND INVISIBLE SURPLUS OF \$2.6 BILLION RESULTED IN CURRENT ACCOUNT SURPLUS OF \$150 MILLION. FOR 1977 SECRETARIAT FORECASTS EXPORT VOLUME GROWTH OF 6-1/2 PERCENT, 8 PERCENT (OR MORE) INCREASE IN IMPORT VOLUME, DETERIORATION IN TERMS OF TRADE AND CURRENT ACCOUNT DEFICIT OF \$400 MILLION. SECRETARIAT DOES NOT SEE RETURN TO CURRENT ACCOUNT DEFICIT AS CAUSE FOR CONCERN IN SHORT RUN.

7. FISCAL AND MONETARY POLICIES: FISCAL POLICY IN 1976 WAS EXPANSIONARY; EXPENDITURE ROSE BY 26 PERCENT COMPARED TO REVENUE GROWTH OF ONLY 18 PERCENT. MONEY SUPPLY (M1) EXPANDED BY 53 PERCENT (YES, 53 PERCENT) IN CONTRAST TO TARGETED INCREASE OF 18 PERCENT. ACCORDING TO SECRETARIAT, MAIN REASON FOR DRAMATIC INCREASE IN MONEY SUPPLY WAS AUTHORITIES' DECISION TO ACCOMMODATE STRONG DEMAND FOR FUNDS ON PART OF FIRMS. YUGOSLAVS PLAN REDUCTION IN BUDGET DEFICIT IN 1977 AND 16 PERCENT GROWTH OF M1.

8. MEDIUM TERM POLICIES AND PROBLEMS. SECRETARIAT SKETCHES BROAD OUTLINES OF NEW YUGOSLAV FIVE YEAR PLAN (1976-80). OBJECTIVES OF PLAN INCLUDE: (A) 7 PERCENT AVERAGE ANNUAL GROWTH OF SOCIAL PRODUCT, (B) EXPANSION AND MODIFICATION OF INDUSTRIAL SECTOR TO REDRESS SECTORAL AND REGIONAL IMBALANCES; (C) EMPHASIS ON IMPORT SUBSTITUTION, EXPORT EXPANSION AND ABSORPTION OF EXPECTED INCREASE IN LABOR SUPPLY (D) DECENTRALIZATION OF ECONOMIC DECISION-MAKING. SECRETARIAT NOTES THAT PLAN DOES NOT CONTAIN EXPLICIT ANALYSIS OF LIKELY AND DESIRABLE DEVELOPMENTS IN PRICES AND NOMINAL INCOMES.

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9. CONCLUSIONS: BASED ON ANALYSIS REFDON, SECRETARIAT SUGGESTS THAT EDRC REACH FOLLOWING MAIN CONCLUSIONS:

(A) RISK OF REACCELERATION OF INFLATION SERIOUS. MORE MODERATE INCREASE IN MONEY SUPPLY THAN CURRENTLY PLANNED WOULD THUS BE IN ORDER. MORE ACTIVE INTEREST AGGREGATES AND CONTRIBUTE TO IMPROVED ALLOCATION OF RESOURCES.

(B) MORE STEADY DEMAND MANAGEMENT POLICIES WOULD BE CONDUCTIVE TO IMPROVED ECONOMIC PERFORMANCE.

(C) ADOPTION OF MORE PROGRESSIVE INCOME TAX STRUCTURE WOULD ENHANCE COUNTER-CYCLICAL IMPACT OF PUBLIC FINANCE.

(D) IMPROVED DEMAND MANAGEMENT POLICIES, SUPPLEMENTED BY INCOMES POLICY, ARE OF GREATER IMPORTANCE TO ACHIEVEMENT OF MEDIUM TERM GOALS THAN IS ESTABLISHMENT OF DETAILED OBJECTIVES OR TARGETS WHOSE ACHIEVEMENT WOULD ENTAIL EXCESSIVE (COMPARED WITH OFFICIAL INTENTIONS) CENTRALIZATION OF DECISION-MAKING.

(E) DEVELOPMENT OF LABOR-INTENSIVE SECTORS NECESSARY TO AVOID RISE IN UNEMPLOYMENT OVER MEDIUM TERM.

10. COMMENT: (A) MISSION AGREES WITH SECRETARIAT

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VIEW THAT 16 PERCENT INCREASE IN M1 PLANNED BY YUGOSLAVS FOR 1977 IS EXCESSIVE GIVEN 53 PERCENT INCREASE LAST YEAR AND WOULD STRESS THIS POINT AT MEETING. IN THIS CONTEXT AS WELL AS IN CONTEXT OF NEED TO IMPROVE

ALLOCATION OF RESOURCES AND TO IMPROVE EMPLOYMENT
OUTLOOK (BY REMOVING SUBSIDY TO CAPITAL FORMATION).
MISSION WOULD SUPPORT SECRETARIAT RECOMMENDATION FOR
REMOVAL OF CONTROLS ON INTEREST RATES.

(B) SECRETARIAT NOTES THAT INVENTORIES (VALUED AT
PRODUCTION COSTS) STOOD AT 65 PERCENT OF SOCIAL PRODUCT
IN 1975. SECRETARIAT DOES NOT SPECULATE AS TO
FACTORS WHICH MIGHT UNDERLIE SUCH HIGH STOCK LEVELS, BUT
ONE REASON COULD BE NEED OF FIRMS TO GUARANTEE SUPPLIES
OF ESSENTIAL INPUTS IN FACE OF POSSIBLE TIGHTENING OF
IMPORT CONTROLS. MISSION WOULD EXPLORE THIS QUESTION
WITH YUGOSLAVS AT REVIEW.

(C) SECRETARIAT STATES THAT OFFICIAL OBJECTIVE TO
"STIMULATE SAVINGS AND REDUCE COST OF BORROWING" OVER
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MEDIUM TERM IS INTERNALLY INCONSISTENT. MISSION AGREES
AND WOULD QUESTION YUGOSLAVS ON THIS POINT.

(D) SECRETARIAT NOTES YUGOSLAV INTENTION THAT USING
SAVINGS BY HOUSEHOLDS IS EXPECTED TO BE A MAJOR SOURCE
OF INVESTMENT FINANCE OVER MEDIUM TERM. HOWEVER,
INSTITUTIONAL RIGIDITIES ARE LIKELY TO HINDER INTER-
MEDIATION PROCESS AND NECESSITATE CONTINUED EXTENSIVE
OFFICIAL INTERVENTION TO DIRECT CREDIT FLOWS. SUCH
INTERVENTION, HOWEVER, WOULD BE CONTRARY TO STATED
OFFICIAL OBJECTIVE OF DECENTRALIZED ECONOMIC DECISION-
MAKING PROCESS. MISSION WOULD RAISE THIS QUESTION
AT REVIEW.

(E) YUGOSLAV RELIANCE ON CHANGES IN INDIRECT TAXES AS
COUNTER-CYCLICAL DEVICE APPEARS QUESTIONABLE SINCE
IT WOULD TEND TO HAVE PRO-CYCLICAL EFFECTS ON INFLATION
RATE, WHILE DEPENDENCE ON CUSTOMS DUTIES AS A MAJOR
SOURCE OF REVENUE PROVIDES ADDITIONAL INCENTIVE TO
RETAIN TARIFFS. MISSION WOULD QUESTION YUGOSLAVS ON
THESE POINTS.
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